

Effective Date: October 7, 1996

**COORDINATED ISSUE  
DATA PROCESSING INDUSTRY  
QUALIFYING WAGES UNDER SECTION 41  
IN DETERMINING THE TAX CREDIT FOR INCREASING RESEARCH ACTIVITIES**

**ISSUE**

Whether remuneration for employment that is excluded from the definition of wages under section 3401(a) of the Internal Revenue Code (the "Code") can constitute qualified research expenses under section 41(b)(2)(A) of the Code in determining the credit for increasing research activities under section 41.<sup>1</sup>

**BRIEF ANSWER**

No. Section 41 grants a tax credit for increasing research activities, which is calculated using the amount constituting a taxpayer's qualified research expenses. In defining qualified research expenses to include wages for qualified services, the Code provides that wages will have the same meaning given under section 3401(a), which defines wages for collection of income tax at source. Under 3401(a), the term wages specifically excludes certain remuneration for employment, including employer contributions to tax-qualified trusts. If certain remuneration is excluded from the meaning of wages under section 3401(a), it cannot constitute wages or qualified research expenses under section 41 for purposes of calculating a tax credit for increasing research activities.

**FACTS**

The Taxpayer develops, manufactures, and sells computer equipment. In carrying on its business, the taxpayer hires employees who perform "qualified services" as defined in section 41(b)(2)(B) of the Code.<sup>2</sup>

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<sup>1</sup>The credit for increasing research activities was initially enacted as section 44F pursuant to section 221 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 293. Section 44F was redesignated as section 30 pursuant to section 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. Section 231(d)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 2, 95, amended the research credit provisions and redesignated section 30 as section 41.

<sup>2</sup>The term "qualified services" means services consisting of--(i) engaging in qualified research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research. See section 41(b)(2)(B). "Qualified

To provide for its employees' retirement, the Taxpayer maintains a qualified profit-sharing plan (the "Plan") under section 401 of the Code. The Plan incorporates a trust satisfying the requirements of section 401(a), making it tax-exempt under section 501(a). The Plan also includes a qualified cash or deferred compensation arrangement meeting the requirements of section 401(k). Under the Plan's deferred compensation arrangement, eligible employees may elect between either receiving cash or having the Taxpayer contribute up to 10 percent of their compensation to the Plan's trust (hereinafter "elective contributions"). Certain eligible employees have so elected to defer their compensation and make elective contributions. The Plan also permits the Taxpayer to contribute an amount for each employee in addition to the employees' elective contributions. Consequently, the Taxpayer contributes an additional amount for each dollar deferred by its employees (hereinafter "matching contributions").

In computing the credit for increasing research under section 41(a) of the Code, the Taxpayer treats both the elective contributions and the matching contributions as qualified research expenses.

### **LAW AND ANALYSIS**

#### **Whether remuneration for employment that is excluded from the meaning of wages under section 3401(a) of the Code can constitute qualified research expenses under section 41(b)(2)(A) of the Code**

Section 41 provides a credit against tax for increasing research activities. This incremental credit equals the sum of 20 percent of the excess of the taxpayer's qualified research expenses for the taxable year over a base amount plus 20 percent of the taxpayer's basic research payments.

The general rule is provided in section 41(a):

For purposes of section 38<sup>3</sup>, the research credit determined under this section for the taxable year shall be an amount equal to the sum of--

- (1) 20 percent of the excess (if any) of--

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research" is defined in section 41(d) but is not directly relevant to the issue present in this paper.

<sup>3</sup>Section 38 of the Code allows a general business credit equal to the sum of the taxpayer's business credit carryforwards, current year business credit, and business credit carrybacks. The research credit under section 41(a) is one of eleven current year business credits. See section 38(b)(4).

(A) the **qualified research expenses** for the taxable year, over

(B) the base amount, and

(2) 20 percent of the basic research payments determined under subsection (e)(1)(A). (Emphasis added).

The term "qualified research expenses" is generally defined as the sum of both the taxpayer's in-house research expenses and contract research expenses that are incurred during the taxable year in carrying on the taxpayer's business. See section 41(b). Pertinent to the issues in this paper is the further definition of one of the elements comprising the term "in-house research expenses." Under section 41(b)(2)(A), in-house research expenses includes "any **wages** paid or incurred to an employee for qualified services<sup>4</sup> performed by such employee."

The term "wages" under section 41 "has the meaning given such term by section 3401(a)." See section 41(b)(2)(D). Thus, the term "wages" under section 41(b)(2)(D) has the same meaning as the term "wages" under section 3401(a) in determining whether certain qualified research expenses qualify for the credit for increasing research activities under section 41. Accordingly, to determine the meaning of wages under section 41, the meaning of wages under section 3401(a) must first be determined.

Section 3401(a) defines wages for purposes of Chapter 24, concerning the collection of income tax at source of wages. Under section 3401(a), wages means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration not paid in cash, subject to certain exceptions. See section 3401(a)(1) - (20). For example, the term wages does not include remuneration paid on behalf of an employee to a trust under section 401(a), which is tax-exempt under section 501(a) at the time the payment is made. See e.g., section 3401(a)(12)(A). For another example, the term wages does not include remuneration paid as fringe benefits under section 132.

In addition, the legislative history to the Economic Recovery Tax Act expressly states that Congress intended the term wages under section 41(b)(2)(D) to have the same meaning as the term wages under section 3401(a). See H. Rept. 97-201 (1981), 1981-2 C.B. 352, 361. This necessarily means that the term wages as defined in section 41 is subject to the same exceptions as wages in section 3401(a). As stated in the House

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<sup>4</sup>The term "qualified services," defined under section 41(b)(2)(B), is comprised of other terms, such as "qualified research," which is defined under section 41(d). The meaning of these terms is not directly relevant to the resolution of the issues presented in this paper and will not be addressed.

Report to the Act: "[A]mounts of compensation which are not subject to withholding, such as certain fringe benefits, do not enter into the credit computation even though paid for service in performing research." H. Rept. 97-201 (1981), 1981-2 C.B. 352, 361. Because elective and matching contributions are excluded from wages under section 3401(a), neither is subject to withholding.

In two recent cases, the Tax Court has construed the term wages under section 41<sup>5</sup> to have the same meaning as wages in section 3401(a). See Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992), acq., 1992-2 C.B. 1; Sun Microsystems, Inc., TCM 1995-69. The Tax Court relied on the statutory language and the legislative history in concluding that section 3401(a) governed the meaning of wages under section 41.

Under 3401(a), wages does not include remuneration paid on behalf of an employee to a trust under section 401(a) that is exempt from tax under section 501(a) at the time of the payment. See section 3401(a)(12). Thus, the employees' elective contributions and the Taxpayer's matching contributions do not constitute wages under section 3401(a). Because these contributions do not constitute wages under section 3401(a), the contributions do not qualify as wages under section 41(b)(2)(D).

Accordingly, the Company cannot include these contributions in its qualified research expenses when it determines any credit under section 41 for increasing research activities.

### **CONCLUSION**

The Taxpayer cannot treat elective and matching contributions as qualified research expenses in determining the credit for increasing research activities under section 41.

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<sup>5</sup>In Apple Computer, Inc., the court considered the term wages in section 44F, which was later redesignated section 41, the current section. See footnote 1.